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**Caveat Emptor: Clarity for Statutory Gratuitous Alienations in Scotland**

**Abstract:** The Scots law equivalent of a "transaction at an undervalue" is a "gratuitous alienation". In a December 2019 judgment, the Supreme Court provided much needed clarity on both "adequate consideration" needed to avoid a transaction being a gratuitous alienation and potential remedies available to the court.

## A. Introduction & Background

On 4 December 2019, the UK Supreme Court handed down its judgment in *Macdonald v Carnbroe Estates Ltd*[1]. This case had been appealed from a judgement of Scotland's second highest civil appeal court, the Inner House of the Court of Session[2], which was in turn an appeal from the first instance case heard by the Court of Session's Outer House.[3]

In delivering the Supreme Court judgment, their lordships (through Lord Hodge's judgment which was agreed by all four other judges) provided considerable clarity for gratuitous alienations under the Insolvency Act 1986. The purposes of this article are to explore the clarity provided, and what it means for purchasers from sellers in financial difficulty.

When a corporate entity in the UK becomes insolvent, certain categories of transactions entered into in advance of such insolvency can be challenged by the insolvency practitioners and/or creditors of the insolvent vehicle.[4] One of these categories arises if the company has given something away within a certain period of time leading to the insolvency of the company. The intention is simply to discourage companies on the brink of insolvency from getting rid of their assets in a way which would hurt their creditors.[5]

Under English law, this is known as a "transaction at an undervalue."[6] A transaction is at an undervalue if the company receives no consideration[7] or receives consideration which, when valued in money's worth, is 'significantly' less than the value of the consideration provided by thecompany in that transaction.[8] It is a defence to a transaction at an undervalue if the company entered into the transaction for good faith for the purposes of carrying on its business[9] and there were reasonable grounds to believe that the transaction would benefit the company.[10] If the court finds that there was a transaction at an undervalue, the court has maximum flexibility in terms of the orders it can grant "for restoring the position to what it would have been if the company had not entered into that transaction."[11] This is only available to transactions within the 'relevant time', being the two year period ending on the date that the company entered into insolvency,[12] and the 'relevant time' can only exist if the company was at that time unable to pay its debts,[13] or became unable to pay its debts as a result of that transaction.[14]

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[1] *Macdonald and another v Carnbroe Estates Ltd* [2019] UKSC 57
[2] [2018] CSIH 7
[3] [2017[ CSOH 8
[4] See discussion in A Keay "The avoidance of antecedent transactions in corporate liquidations: the Australian regime" 1995 International Insolvency Review 139
[5] See R J de Weijs "Towards an Objective European Rule on Transaction Avoidance in Insolvencies" (2011) 20 International Insolvency Review 219
[6] Insolvency Act 1986 s238
[7] Insolvency Act 1986 s238(4)(a)
[8] Insolvency Act 1986 s238(4)(b)
[9] Insolvency Act 1986 s238(5)(a)
[10] Insolvency Act 1986 s238(5)(b)
[11] Insolvency Act 1986 s238(3)
[12] Insolvency Act 1986 s240(1)(a)
[13] Insolvency Act 1986 s240(2)(a)
[14] Insolvency Act 1986 s240(2)(b)

By contrast, Scots law prohibits gratuitous alienations. Scots law prohibited gratuitous alienations at common law, which remains relevant.[15] In addition, the Insolvency Act has a statutory formulation of the prohibition on gratuitous alienations.[16] The statutory formulation is much more verbose than the English equivalent. So under Scots law, any transfer of assets, or renunciation of a claim, is challengeable if it is made within the "relevant time".[17] Thus the starting point is that more elements can fall under the first stage of being a gratuitous alienation than would under the first stage of identifying a transaction at an undervalue, as under the former, all transfers fall in the first stage, whereas under the latter only transactions at an undervalue do. The "relevant time" is, as with English law, a period of time ending on the date that the company enters into insolvency, such period in Scotland being five years for connected parties[18] and two years for all others.[19] If the category of what falls into gratuitous alienations is wider than the English equivalent, so are the defences. There are three defences. Firstly, it is a defence if at any time after the alienation the company's assets were greater than its liabilities.[20] Secondly, it is a defence if the transfer was a gift which was reasonable for the company to make.[21] Thirdly, it is a defence if adequate consideration was received.[22]

*Macdonald v Carnbroe* concerned the third defence, and explored what is meant by adequate consideration. It also explored the potential remedies available under Scots law should a transfer not be found to be for adequate consideration.

We shall explore these in turn.

## B. Adequate Consideration

Whether adequate consideration has been provided seems easy to identify. Buying something for £2 which is worth £5 is clearly not adequate consideration. The issue arises, however, when pressures of business life make it unclear how much an asset in question is "worth". This arose in *Macdonald v Carnbroe,* which focused on the events leading up to the insolvency of Grampian MacLennan's Distribution Services Ltd, in particular involving a property owned by Grampian. Grampian purchased this property for £630,000 in 2005, but by 2014 it was in need of upgrading.[23] By 2013, Grampian's financial position had deteriorated and a valuation provided that the property was worth £1,200,000 on the open market, or £800,000 if the sale needed to be rushed through in 180 days.[24] Carnbroe offered to buy the property for £950,000, but Grampian did not sell – instead, the shareholders of Grampian sold their shares to a third party.[25] The new owner hoped to save Grampian, but a withdrawal of working capital funding resulted in Grampian's cash flow collapsing.[26] As a result, it became known by a few people, including Carnbroe's shareholder, that Grampian were in financial difficulties and wanting to sell the property, and that the principal debt funder to Grampian (who held security over the property) were likely to try to accelerate their loan.[27] The property sold for £550,000, with £473,604.68 (sufficient to redeem the principal debt funder) being paid directly to the principal debt funder, and the rest of the purchase price being left outstanding as deferred consideration. Whilst this repaid Grampian's principal funder, it left Grampian's other creditors unpaid, and without the

[15] Insolvency Act 1986 s242(7)
[16] Insolvency Act 1986 s242
[17] Insolvency Act 1986 s242(2)(a)
[18] Insolvency Act 1986 s242(3)(a)
[19] Insolvency Act 1986 s242(3)(b)
[20] Insolvency Act 1986 s242(4)(a)
[21] Insolvency Act 1986 s242(4)(c)
[22] Insolvency Act 1986 s242(4)(b)
[23] (n 1), para 2
[24] (n 1), para 3
[25] (n 1), paras 3-4
[26] (n 1), para 5
[27] (n 1), paras 5-6

means for Grampian to generate more profit. HMRC petitioned to wind up Grampian, and liquidators were appointed.[28]

The first issue was, therefore, whether Grampian received adequate consideration for the transfer. It was generally agreed that £550,000 was not unreasonable for the property with no marketing, but that with marketing the property could have fetched a much higher price. At first instance, the court pointed out that Grampian desperately needed funds to repay their principal debt funder, and that Carnbroe's offer enabled them to save costs of marketing and estate agency fees.[29] At first appeal, the court considered that the transaction did not save, and could not have saved, the business as a going concern, and as such it was not appropriate to proceed on the basis of no marketing.[30] For the Inner House (the first appeal court), the issue was purely about liquidity. They stated:

> "we are of the opinion that the need for a forced sale to provide immediate liquidity is not normally a factor that should be taken into account in determining the adequacy of consideration obtained for a sale of the debtor's assets in any case where the debtor has ceased business or is about to cease business."[31]

As a result, whilst the first instance held that Grampian were justified in receiving a lower price for a quicker sale, the first appeal court held that this was not the case – and would not normally be the case if business had ceased or was due to cease shortly. Carnbroe appealed on the grounds of facilitation of commercial transactions and certainty that concluded transactions would not be re-opened.[32]

Thus, by the time that the case came to the Supreme Court, there were two formulations which had already been explored: that Grampian's perceived need for liquidity justified the reduction in price; and that liquidity could not be relevant. These can be reformulated into broader statements – whether a subjective or objective approach should be taken to the justification to proceed on the basis of obtaining a lower price in exchange for a quick sale.

The Supreme Court reviewed the relevant caselaw and identified that an objective approach should be taken to any justification for calculating the "worth" of the asset on a lower basis in exchange for speed of transaction execution.[33] They agreed with the Inner House that accepting a reduced price for a speedy sale was not objectively justified when the business had ceased trading. Lord Hodge identified that the holder of a standard security (the Scottish equivalent of a legal mortgage over land) had a duty to obtain the best value when enforcing their security.[34] He held that this, together with the duties owed by insolvency practitioners, should be applied during a pre-insolvency process insolvent wind-down, stating:

> "In my view, where the directors of an insolvent company are conducting an informal winding up by disposing of the company's assets and are unable as a result of circumstances beyond their control to carry out a full marketing exercise, the sale should be measured against that standard….it is necessary to have regard to these duties imposed on the insolvency practitioner and the holder of a standard security…"[35]

Thus we now know – the decision to accelerate marketing in order to obtain a quick sale is not justifiable when the directors are in the process of an informal insolvent wind-up of the company. This is coherent – by the point in time, the interests of the company transfer to being the interests of the creditors,[36] and

[28] (n 1), para 11
[29] (n 3), paras 30 – 31.
[30] (n 2) paras 27 – 30.
[31] (n 2) para 25; (n 1) para 17
[32] (n 1) para 18
[33] (n 1) para 32
[34] (n 1) para 38; Conveyancing and Feudal Reform (Scotland) Act 1970 s25
[35] (n 1) para 39
[36] *Liquidator of West Mercia Safetywear Ltd v Dodd and another* [1988] 4 BCC 30; *Colin Gwyer and Associates Ltd and another v London Wharf (Limehouse) Ltd and others* [2003] BCC 885

directors may risk personal liability for wrongful trading if they knew or reasonably ought to have known that there was no chance of the company avoiding insolvency liquidation.[37] It would therefore be incoherent if, at the same time, directors were able to justify obtaining a lower price for an asset due to a need for a quick sale. The company is being effectively wound up on an insolvent basis anyway, and so there is no advantage to obtaining immediate liquidity at the cost of long-term value: the worst is already happening and the company's operations are being terminated.

This is clear where, as in *Macdonald v Carnbroe*, the effect of the sale removed the company's profit generating ability. There are, therefore, situations like this where the test will be easy and clear. However, there are many more situations where the position will not be clear, especially to a third party purchaser. It is clear from the *Macdonald* judgment that the shareholders of Carnbroe knew about the financial distress of Grampian. But this is also irrelevant – even if Carnbroe were a total outside purchaser with no knowledge of Grampian's financial position, the answer would still be the same.

Lord Hodge said:

> "Where the directors of the insolvent company, mindful of their duty to creditors, have an opportunity to place a property on the market and carry out a proper marketing exercise to enhance the price which the property will command, "adequate consideration" should be measured against the likely result of such an exercise. Where the insolvent company is not able to support such a marketing exercise, the adequacy of the consideration achieved on a sale is to be measured by comparing the consideration which the insolvent company has accepted against the likely outcomes which a formal insolvency would achieve through the sale or other disposal of the asset by a liquidator or administrator…"[38]

This concentrates solely on the position of the seller, which leaves purchasers in an uncomfortable position. If Grampian used the liquidity gained from the sale to fund a rescue package, Carnbroe would have benefitted from making the quick sale. As it is, they are faced with their purchase being challenged. Whilst it is hard to feel sympathy for Carnbroe, the issue transcends the facts of this case: purchasers bear the risks of speedy sales and of buying below a value which could be achieved for a long period of marketing. This case is one extreme, but the same principles must apply to an unconnected purchaser who puts in a low bid for a quick sale at the start of a marketing period. If the seller then became insolvent, there is a risk that this is challenged as not being justifiable in the circumstances. This means that whether the sale is subsequently challengeable or not is entirely independent to the actions of the purchaser. Indeed, whether the basis of the value that the sale was conducted at was justifiable depends on what the seller then does with those proceeds. In some circumstances, the seller may have a work-out plan which requires immediate liquidity but does not work that the court ex poste considers to objectively justify a quick sale. In others, the seller may use the liquidity frivolously and so the court would consider the basis of the transaction to be not objectively justified. The issue arises that it is only after the fact that it is known whether the basis for the valuation of the transaction is justifiable or not. Accordingly, any buyer taking part in any quick sale of any asset by the directors of any company risk the sale being unpicked after by the court deciding that the quick sale was not objectively justifiable.

It is worth considering the position under English law. It is a defence to a challenge of a transaction at an undervalue if the court is satisfied:

> "(a) that the company which entered into the transaction did so in good faith and for the purpose of carrying on its business, and

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[37] Insolvency Act 1986, s214

[38] (n 1) para 37

(b) that at the time it did so there were reasonable grounds for believing that the transaction would benefit the company."[39]

It has been stated that limb (a) is a subjective test, whereas limb (b) is an objective test.[40] Both elements are relevant only to the seller and not the buyer.[41] In *Carnbroe* there is no allegation of anything other than good faith. English courts have held that deferred consideration due from a company with a poor covenant did not pass the objective aspect of this test.[42] The issue, however, is whether the *Carnbroe* case would satisfy it. It is generally considered that cash flow problems are able to justify a lower price under English law.[43] However, the objective element must also mean that under English law this justification is at risk of the same challenge that occurred in *Carnbroe:* in the case of an informal wind up, it is unlikely to be objectively justifiable to push for a quick sale and thereby achieve a lower price.

Now, the result in *Carnbroe*, and the law emanating from it, is clearly coherent and logical. However, it is worth pausing to consider whether it exposes good faith purchasers to unnecessary risk. Such purchasers are likely to be pressured into speedy acquisitions by directors of companies with liquidity needs who feel confident that their workout strategies will, of course, be nothing but successful. This has long been noted as an iniquitous position, as Prof Fletcher stated:

> "Although this provision was possibly designed to ensure that, inter alia, persons acquiring goods or services at 'sacrificial' prices in an event aimed at alleviating a company's cash-flow problems should be assured of retaining their 'bargains', it should be noted that their legal position is apparently unrelated to the state of their own knowledge or intentions at the time in question, but is made to depend upon a combination of subjective and objective factors, lying in many cases beyond their realm of knowledge or discovery, regarding the affairs of the company with which they are dealing."[44]

*Canbroe* is a timely reminder to us all that Prof Fletcher's concern, that a good faith purchaser's title to the relevant assets is entirely unconnected to their own actions or intent, remains as relevant as ever and applies both north and south of the Tweed.

### C. Remedy

*Macdonald v Carnbroe* has also provided much needed exposition of the remedy that is available should a gratuitous alienation be identified. Whilst, as noted above, the English law provisions only refer to the court deciding the appropriate remedy, under the Scottish section:

> "the court shall grant decree of reduction or for such restoration of property to the company's assets or other redress as may be appropriate"[45]

This wording appeared in other Scottish insolvency legislation.[46] Prior to this case, the interpretation of this provision was particularly punitive to purchasers. The case of *Short's Trustee v Chung*[47] involved a purchase of two flats at an undervalue by a man who then transferred those to his wife immediately for no consideration. The court held that this statutory formulation represented a hierarchy – first, reduction was the appropriate remedy if at all possible, failing which some form of restoration or other redress. They stated:

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[39] Insolvency Act 1986 s238(5)
[40] See A R Keay *McPherson's Law of Company Liquidation* (4th Edition, Sweet & Maxwell, 2017) para 11-041 to 11-043
[41] E.g. *Re Barton Manufacturing Co Ltd* [1998] B.C.C. 827 .
[42] *Lord (Liquidator of Rosshill Properties Ltd) v Sinai Securities Ltd* [2004] BCC 986
[43] R Parry, and others *Transaction Avoidance in Insolvencies*, (2nd Edition, OUP, 2011), para 4.93
[44] I Fletcher "Voidable Transactions in Bankruptcy: British Perspectives" in J S Ziegel (ed.) *Current Developments in International and Comparative Corporate Insolvency Law* (Clarenden Press, 1994), p.304 – 305,
[45] Insolvency Act 1986 s242(4)
[46] E.g. Bankruptcy (Scotland) Act 1985 s34
[47] *Short's Trustee v Chung* 1991 SLT 472

> "We consider that the reference to "other redress as may be appropriate" is not intended to give the court a general discretion to decide a case on equitable principles but is designed to enable the court to make an appropriate order in a case where reduction or restoration of the property is not a remedy which is available. As reduction is available in this case, we consider that it is the proper remedy and for this reason we would refuse the reclaiming motion."[48]

With respect to the court, it is difficult to agree to this interpretation. The formulation clearly has three limbs, each separated by an "or". As a matter of linguistics, this implies that the court can choose any of the three options. Parliament could have expressly included a hierarchy in this formulation if they wished to,[49] and yet did not. This left purchasers with an even bigger risk – if they bought a property at an undervalue, on insolvency of the debtor (assuming it took place within the relevant time) the transaction would be unwound, and the asset would return to the insolvent company's estate. If the purchaser received the property for free, then this would be one thing. However, the real risk occurred for any amount that the purchaser had paid for the property. The purchaser's remedy was to claim as an unsecured creditor against the company for any amount they had paid across. So if a purchaser acquired a property for £999,999 which was worth £1,000,000, the amount of the undervalue represented 0.0001% of the value of the property. However, under the *Short's Trustees* interpretation, the correct approach was to return the property to the insolvent company, and for the purchaser to claim for £999,999 as an unsecured creditor in the insolvent company's estate. This is likely to leave the purchaser at a severe detriment as they are very unlikely to recover in full. Only if it were not possible to prove in the estate (not to receive full recovery, but to prove in the estate) would the logical solution, for the purchaser to pay £1 to the seller, be awarded. This approach has been followed by the Scottish courts as being the correct interpretation.[50]

If we factor in that a purchaser may have, after the acquisition, spent money on the property to improve it still further, the inequity of the legal outcome in *Short's Trustee* becomes even clearer. This would be exacerbated by the first part of the *Macdonald v Carnbroe* Supreme Court judgment. Even if purchasers knew that they had paid adequate consideration under a certain measure of value, they could not be certain whether that measure of value would be seen to be objectively justifiable or not. Accordingly, this seems to increase uncertainty and risk for purchasers. Luckily, however, the Supreme Court in *Macdonald v Carnbroe* adjusted the position in respect of the approach to remedies.

The Supreme Court did so in a rather clever way. Firstly, they agreed that the primary remedy was, and always had been, to set aside the transaction, and that the court had no 'general equitable jurisdiction'.[51] However, they went on to state:

> "An order for the restoration of the property to the insolvent company, which leaves the transferee to prove in competition with other creditors for the price which it originally paid, not only is harsh on the transferee but also gives the general body of creditors an uncovenanted windfall as the company would not have received the price but for the impugned sale."[52]

This flags the potential injustice to the purchaser of the *Short's Trustees* formulation, but also the unjustified benefit to the creditors of the seller: in our example, the seller received £999,999 it would not have done were it not for the fact that the sale took place. Lord Hodge identified that the legislation did not identify a hierarchy, stating "in my view the statutory words are broad enough to allow the court to take account of the consideration which a bona fide purchaser has paid the insolvent in devising an appropriate remedy."[53] Lord Hodge then identified that, in order to reduce a transaction, both sides to the transaction need to be

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[48] (n 47) 476
[49] Indeed, they eventually did in the context of administration within the same act – see Insolvency Act 1986 Sch B1 para 3. I am grateful to Scott Wortley for identifying this parallel.
[50] *Cay's Trustee v Cay* 1998 SC 780; *Baillie Marshall Ltd v Avian Communications Ltd* 2002 SLT 189; see discussion in (n 1) paras 47 - 48
[51] (n 1) para 49
[52] (n 1) para 51
[53] (n 1) para 53

able to be put in the same position as they were before the transaction.[54] He identified prior authority for partial annulments of transactions, and recoveries of balancing payments prior to the statutory formulation.[55] The court identified that there may be situations whereby it was appropriate to annul the transaction and leave the purchaser with only an unsecured claim, especially where the purchaser is associated with the seller. However, Lord Hodge's judgement went on to state:

> "But there would in my view need to be clear statutory words to require the court in all circumstances to penalise the purchaser of property who had no knowledge or incomplete knowledge of the circumstances of the insolvent and who was not colluding to remove assets from the reach of the insolvent's creditors. There are no such words in that subsection."[56]

Accordingly, the court retained discretion to pick which of its three options were the fairest: sometimes a return of the property, sometimes a balancing payment of £1. This goes some way to reduce the risk of the effect of gratuitous alienation, but does not fully ameliorate the risk that the basis of the value of the sale be deemed, after the fact, to be objectively unjustifiable and thus open to challenge.

### D. Conclusion

The Supreme Court's ruling in *Macdonald v Carnbroe* thus provides a mixed bag for the purchasers of assets with an accelerated marketing timeframe. On one hand, the risk that they will lose all of the price they have already paid to the insolvent company has decreased considerably with the judgment. On the other hand, the risk that their transaction is held to be a gratuitous alienation has increased, as the court have clarified that the basis for the valuation of the worth of the asset depends, on the approach to insolvency, on what the seller does with the purchase price. This is a coherent and logical approach, but does somewhat beg the question as to whether good faith purchasers buying from sellers in financial difficulty need more protection.

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[54] (n 1) para 58
[55] (n 1) paras 60 - 62
[56] (n 1) para 64